F. UPDATE ON UNRELATED BUSINESS TAXABLE INCOME

1. Introduction

The area of unrelated business taxable income continues to have a high profile. With on-going litigation, Congressional involvement, and newly identified issues, unrelated business income retains its significance in the world of exempt organizations. This topic is intended to update Developments in Unrelated Business Taxable Income appearing in last year's CPE Text at p. 9. Last year two Supreme Court decisions, American Bar Endowment and American College of Physicians, dominated the discussion. In addition, certain lower court decisions were described, and the possibility of Congressional hearings was announced.

This year, although there are no Supreme Court decisions in the area of unrelated business income, a number of interesting lower court decisions have been reported affecting advertising income, social clubs, and the sale of low cost articles. Each of these decisions will be discussed. Also, reference will be made to last summer's Congressional hearings and some newly identified issues will be presented.

2. Congressional Hearings

Last year's CPE topic reported that the Chairman of the House Ways and Means Committee, Dan Rostenkowski, requested the Chairman of the Oversight Subcommittee, J. J. Pickle, to conduct a comprehensive review of the federal tax treatment of commercial and other income producing activities of exempt organizations. Congressman Rostenkowski asked the Oversight Subcommittee to examine the policy considerations underlying the appropriate tax treatment of income-producing activities of tax-exempt organizations, the impact of present law rules on both tax-exempt organizations and for-profit businesses, as well as the Service's application of, and taxpayer compliance with, the law. The Subcommittee was also directed to determine whether the current rules set forth the appropriate standards for determining the taxability of the income-producing activities of tax-exempt organizations, and the effect of such activities on tax-exempt status.

Over a period of five days beginning on June 22, 1987, the Oversight Subcommittee held hearings on unrelated business taxable income. Subcommittee Chairman Pickle stated that the purpose of the hearings was to gain an understanding of what is occurring in the unrelated business income area, which

has not been comprehensively reviewed since 1969. The Subcommittee heard approximately 100 witnesses representing the nonprofit sector, the business community, and the academic world. Representatives from Treasury, the General Accounting Office, the Small Business Administration, and the Service provided testimony on behalf of the government. Senator Terry Sanford and Rep. Fortney (Pete) Stark also spoke before the Subcommittee.

In summary, those speaking on behalf of exempt organizations were of the opinion that current law is adequate, that additional reporting requirements might be acceptable, that Congress should proceed cautiously in considering legislative changes, and that complaints of competition are merely anecdotal. These witnesses testified that additional factual data are required. Business representatives attempted to convince Congress that a significant problem exists that requires immediate legislative action, that current law is not working, and that there is inadequate enforcement.

At the time this topic was being prepared, the Oversight Subcommittee was still considering the information and testimony presented at the hearings. Although no recommendations have yet been made by the Subcommittee, future legislative changes are possible.

3. Advertising Income

A. American Hospital Association v. United States

Background

The U.S. District Court for the Northern District of Illinois considered the effect of free distribution of periodicals on advertising income in American Hospital Association v. United States, 654 F. Supp. 1152 (N.D. Ill. 1987). American Hospital Association (AHA), which is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(6), has three categories of membership: institutional members, individual members, and associate members. During the years in question, AHA published several periodicals, the principal one being Hospitals, Journal of the American Hospital Association, which contains articles and advertising. Periodicals were sent free of charge to dues-paying members, sold to nonmembers, and sent free of charge to a "controlled circulation group." This latter group was comprised of various persons employed in the health care industry, including hospital and nursing home administrators, purchasing agents, engineers, food service managers, chief pharmacists, and executive

housekeepers. Members of the controlled circulation group received the periodical regardless of whether they were members of AHA or employed by members of AHA. The reason given for free distribution of the periodicals was to increase the periodical's attractiveness to advertisers. During the years in question more than one-third of AHA's periodicals were sent to dues-paying members, over one-tenth were sold to nonmembers, and exactly one-half were distributed free of charge to the "controlled circulation group." For each year, advertising revenue totaled approximately $1.7 million, with subscription revenues amounting to approximately $100,000.

Issue and Arguments

The question presented is whether free distribution of AHA's periodicals to nonmembers should be included in total circulation for purposes of Reg. 1.512(a)-1(f)(4)(i). Under Reg. 1.512(a)-1(f)(1) and 1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business. Reg. 1.512(a)-1(f)(6)(ii) states that direct advertising costs of an exempt organization's periodical include all expenses, depreciation, and similar items of deduction which are directly connected with the sale and publication of advertising. Deductible items under this provision do not include any items of deduction attributable to the production or distribution of the readership content of the periodical. However, under Reg. 1.512(a)-1(f)(2), costs associated with the readership content of the periodical may be deducted from advertising income to the extent readership costs exceed circulation income. Circulation income is defined in Reg. 1.512(a)-1(f)(3)(iii) as the income attributable to the production, distribution, or circulation of a periodical. Where the right to receive a periodical is associated with membership in an exempt organization, for which dues or fees are received, circulation income includes the portion of membership receipts allocable to the periodical.

Reg. 1.512(a)-1(f)(4) contains three different methods of calculating allocable membership receipts. Under the first method, if 20 percent or more of the total circulation of a periodical consists of sales to nonmembers, the subscription price charged will determine the price of the periodical for purposes of allocating membership receipts to the periodical. Under the second method, if membership dues from 20 percent or more of the members of an exempt organization are less than those received from other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical will determine the price of the periodical for purposes of allocating membership receipts to the periodical. Under the third

method - the so-called pro rata method - if the organization fails to meet the 20 percent tests of the first two methods, the share of membership receipts allocated to the periodical will be an amount equal to the organization's membership receipts multiplied by a fraction, the numerator of which is the total periodical costs, and the denominator of which is such costs plus the costs of other exempt activities of the organization.

AHA argued that the first method under Reg. 1.512(a)-1(f)(4) is the appropriate method for determining its allocable membership receipts. In AHA's view, free distributions to nonmembers should not be included in determining whether the 20 percent test is met. If free distribution of the periodical is excluded, then AHA would meet the 20 percent test for purposes of the first method. If the first method is used, $10 and $15 per member for each of the two years in question would be utilized for purposes of allocating membership receipts to the periodicals.

The Government argued that AHA did not meet the 20 percent test, and therefore the first method is inapplicable. Since the second method is also not available to AHA, the third method, or pro rata method, for calculating allocable membership receipts would have to be used. In the Government's view, the free distribution of the periodical to the controlled circulation group should not be excluded from total circulation and, therefore, AHA would fall far short of the 20 percent requirement. Using the pro rata method would result in the allocation of more than $50 per member for each year.

Holding

The court agreed with AHA in holding that the term "circulation" appearing in Reg. 1.512(a)-1(f)(4)(i) should be construed as applying only to paid circulation, and free distribution of the periodical should be excluded in determining whether the 20 percent test is met. The court arrived at its decision by "look(ing) beyond the language of the regulation to its purpose in determining its meaning." The opinion refers to the general Congressional intent behind taxing unrelated business income of placing private businesses on the same equal level with competing businesses operated by exempt organizations. The subscription price of a periodical was viewed by the court as a reasonable, objective indicator of market value. Thus, the first method of allocating membership receipts under Reg. 1.512(a)-1(f)(4)(i) was seen as being preferable to the "last resort" pro rata allocation method under Reg. 1.512(a)-1(f)(4)(iii). The belief was expressed by the court that the subscription price truly reflects what an unrelated party would have paid AHA in an arm's length transaction, and that AHA has not manipulated the

subscription price in an attempt to avoid unrelated business income tax. Persuasive factors included the significant ratio of paying nonmember subscribers (approximately 9,400) to member subscribers (approximately 27,600) yielding 34 percent; the fairly large number of paying nonmember subscribers; and, the periodical's subscription price being similar to comparable commercial periodicals. The large number of free distributions (approximately 36,300) was not discussed. Also persuasive to the court was Technical Advice Memorandum 8403013, which stated that free copies of a periodical published by an exempt organization are not included in determining total circulation or the number of nonmember sales under Reg. 1.512(a)-1(f)(4)(i).

Postscript

The holding in American Hospital Association v. United States is inconsistent with the Service position advanced in court, which is that "total circulation" for purposes of Reg. 1.512(a)-1(f)(4)(i) must include periodicals distributed free of charge to nonmembers. By excluding free distributions to nonmembers, the plain meaning of "total circulation" is ignored, and the economic reality of advertising income is distorted. In fact, failing to include free distribution of periodicals as part of total circulation results in approximately one-half of AHA's periodicals being removed from the allocation method of the regulations. Appropriate steps are being taken to modify the erroneous statement cited by the court from Technical Advice Memorandum 8403013 concerning free copies not being included in total circulation.

At the time this topic was being written, no final decision had been reached as to whether the case will be appealed. The court's opinion addressed only one of the issues being considered in this case. Other issues are currently pending.

B. American Medical Association v. United States

Background

The U.S. District Court for the Northern District of Illinois issued another opinion on advertising income in American Medical Association v. United States, Civ. No. 82-C-7213 (N.D. Ill. June 22, 1987; Supplemental Opinion September 2, 1987). American Medical Association (AMA), which is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(6), published various medical periodicals, the most prominent of which are Journal of the American Medical Association (JAMA), and American Medical News (AM News). AMA

also published a number of specialty journals. AMA has four categories of membership: regular dues-paying members, interns and residents, medical students, and dues-exempt members. Membership in AMA entitles the member to receive without additional payment JAMA, AM News, and one of the specialty journals. AMA sells advertising in its periodicals primarily to pharmaceutical companies. Periodicals are sent free of charge to a "control group" of nonmember physicians. In 1977, 175,422 copies of JAMA were sent to AMA members, 66,210 were attributed to member controlled circulation, 39,122 were attributed to nonmember controlled circulation, and 32,788 were sent to paid subscribers. In 1975 through 1978, dues collected by AMA were used, in part, to defray activity costs, while the remainder was placed in an "association equity fund" - a reserve fund of liquid assets to be used in the event of a future activity cost deficit.

Issues

Six separate issues were addressed by the court with respect to AMA's advertising income:

(1) Whether the costs of producing and distributing the readership content of periodicals distributed free of charge to nonmember physicians in the control group should be treated as fully deductible direct advertising costs, rather than partially deductible readership costs;

(2) Whether, in calculating membership receipts allocable to circulation income under Reg. 1.512(a)-1(f)(4)(iii), dues placed in the association equity fund rather than used to pay activity costs should be included in total membership receipts;

(3) Whether, in calculating membership receipts allocable to circulation income under Reg. 1.512(a)-1(f)(4)(iii), dues collected from AMA members in the control group who would have received the periodicals free of charge even if they had not been dues-paying members should be included in total membership receipts;

(4) Whether, under Reg. 1.512(a)-1(f)(4)(iii), the total costs of all other AMA periodicals, not just readership costs, should be included as part of the cost of other exempt activities;

(5) Whether, in calculating membership receipts allocable to each specialty journal's circulation income under Reg. 1.512(a)-1(f)(4)(i), the one year

or two year subscription rate charged to nonmembers should be used; and

(6) Whether, in calculating membership receipts under Reg. 1.512(a)-1(f)(4)(i), only a percentage of reduced dues should be used to determine the price of the periodical for AMA members paying such reduced fees.

Issue 1

With respect to the first issue, AMA argued that since it sent periodicals to nonmember physicians solely to generate advertising revenue, it should be able to deduct all costs, even those attributable to readership content. AMA's justification for this approach is that an item of deduction is directly connected with the production or distribution content of a periodical only if the dissemination of the readership content for its own sake is a primary purpose of the item. AMA asserted that if costs are incurred solely for the purpose of increasing advertising revenues, they are not directly connected with readership content. The Government cited Reg. 1.512(a)-1(f)(6)(ii), which provides that deductible direct advertising costs do not include any items of deduction attributable to the production or distribution of the readership content of the periodical. In accordance with this provision, a per se rule is created whereby costs attributable to, or directly connected with, the production and distribution of the readership content (as opposed to the direct advertising content) of a periodical cannot be directly connected with the sale and publication of advertising and, therefore, are not deductible as direct advertising costs. The court agreed with AMA's argument and held that it should be permitted to deduct the readership content cost of periodicals distributed to control group physicians to generate advertising revenue. The court reasoned that although nonmember physicians reading the periodicals may read and learn from the readership content, this does not alter AMA's income-generating motivation for sending free periodicals. The court viewed the per se rule of the regulation as being without justification and, instead of adopting the per se rule, the court emphasized that exempt organizations and taxable entities should be treated in a similar manner. In the court's view, AMA, like its commercial counterparts, should be permitted to deduct readership content costs when they are incurred solely to generate revenue rather than to further exempt purposes.

Issue 2

With regard to the "association equity fund", AMA argued that Reg. 1.512(a)-1(f)(4)(iii) should be construed to exclude from each year's total

membership receipts any dues collected that year but placed in the separate account. In AMA's view, because these dues were not actually used for any activity costs (including periodical costs) in the year collected, there is no basis for concluding that a portion of such dues was used for the costs of a particular periodical during that year. AMA would prefer to include membership receipts in the year they are taken from the association equity fund and actually used for activity costs. The Government cited Reg. 1.512(a)-1(f)(3)(iii), which defines membership receipts as "dues, fees or other charges" covering all dues regardless of whether they are used for activity costs. Also, the Government raised the issue of unfairness resulting when members are permitted to deduct dues paid to AMA, which did not treat such dues as receipts, together with the potential for widespread tax avoidance. Despite these arguments, the court agreed with AMA in interpreting membership receipts in a given year for purposes of Reg. 1.512(a)-1(f)(4)(iii) to mean dues, fees or other charges used for activity costs in that year. The Government's arguments concerning unfair treatment and possible tax avoidance were rejected by the court.

Issue 3

On the third issue, AMA attempted to persuade the court that dues of member physicians, who would have received the periodical as part of the controlled circulation even if they had not been dues-paying AMA members, should be excluded from the allocation method under Reg. 1.512(a)-1(f)(4)(iii). AMA reasoned that circulation income should approximate the amount that would be charged and paid by members if the periodical was that of a taxable organization published for profit; commercial publishers would not charge AMA control group members for the periodical; and, equal tax treatment could only be achieved if the dues of those AMA members were excluded from total membership receipts. The court rejected these arguments, noting that the control group AMA members had to and did pay dues to be members, and those dues were available to defray periodical costs. The court thought that it is irrelevant that a commercial publisher would not have charged the control group members for periodicals. In the court's view, Reg. 1.512(a)-1(f)(4)(iii) properly calls for the inclusion of the dues of AMA control-group members in total membership receipts.

Issue 4

The fourth issue revolves around an interpretation of the phrase "cost of other exempt activities" under Reg. 1.512(a)-1(f)(4)(iii). Both AMA and the Government agreed that where an organization published only one periodical or

publishes more than one but consolidates, the total costs of all periodicals are included in both the numerator and denominator. Under AMA's approach, "total periodical costs" for any one periodical would be the full costs of the periodical, while "cost of other exempt activities" for the same periodical would be the cost of all other exempt activities including the total costs of all other periodicals. The Government position was that "cost of other exempt activities" as to any periodicals should include only the readership costs of other periodicals. Under the Government's approach, AMA would not be harmed because it could have chosen to consolidate its publications. The court decided that the cost of other exempt activities in the denominator includes all costs of other periodicals, not just readership costs. In finding for AMA, the court sought to equalize treatment for organizations that consolidate and those that do not. The court stated that excluding costs other than readership costs of AMA's other periodicals was not justified, since all costs of the individual periodicals are included in the fraction.

Issue 5

Issue five concerns the allocation of membership receipts under Reg. 1.512(a)-1(f)(4)(i). AMA argued that one-half the two year subscription rate, or $14, should be used, while the Government sought to use the one year subscription rate of $18. The court agreed that the one year subscription rate was correctly used in determining the price of the specialty periodical.

Issue 6

The final issue also concerned an interpretation of Reg. 1.512(a)-1(f)(4)(i) as it applies to reduced dues paid by students, interns and residents. Regular dues-paying members paid $250 annual dues, while interns and residents paid $35, and students paid $15. The Government attempted to have the full $18 amount treated as the price of the periodicals sent to the reduced dues-paying members. AMA criticized this approach as being "irrational". The court stated that it would be unreasonable to allocate $18 to the circulation income of a medical student who pays $15 in total dues. The court was similarly displeased with the treatment of interns and residents, and chose to create its own test. The court decided to determine what percentage of the annual dues of a full dues-paying member is allocable to a periodical's circulation income, and then allocate that percentage of dues from members, who pay reduced dues, to the periodical's circulation income.

Supplemental Opinion

Following the initial opinion, the court in American Medical Association v. United States issued a supplemental opinion that addressed the validity of the advertising income regulations under Reg. 1.512(a)-1(f). AMA had urged the court to hold that the advertising regulations are invalid because they are inconsistent with IRC 512(a)(1) or, alternatively, that Reg. 1.512(a)-1(f)(4) is invalid because it was promulgated without the notice required under the Administrative Procedure Act.

The court found that Reg. 1.512(a)-1(f) is a reasonable implementation of IRC 512(a)(1) and, therefore, is a valid regulation. However, the court did hold that Reg. 1.512(a)-1(f)(4) is invalid, because it was not properly promulgated. The court viewed the adopted regulation as being "drastically different" from the proposed regulation and, because it was issued without any separate notice of the changes, it was promulgated without the required notice under the Administrative Procedure Act. The court stayed any further action until a regulation is promulgated that takes the place of the invalidated regulation. AMA's refund will be delayed pending adoption of a new regulation.

Postscript

In many ways the decision in American Medical Association v. United States is troublesome. By permitting AMA to deduct the entire cost of producing and distributing periodicals sent to the control group under a primary purpose test, the court has effectively rejected the fragmentation test under IRC 512(c) and the regulations thereunder, which attempts to segregate amounts of income and expenses depending on whether they are derived or incurred in connection with an exempt activity or an unrelated trade or business. The court's holding on this issue is also contrary to Reg. 1.512(a)-1(f)(6)(ii), which precludes readership costs from being deducted from direct advertising costs. Equally problematic is the holding with respect to the association equity fund. This holding ignores the plain language of Reg. 1.512(a)-1(f)(3)(iii), which indicates that membership receipts (not a portion of membership receipts) are taken into account in computing allocable membership receipts. The holding ignores basic income tax rules whereby gross income may not avoid inclusion by being assigned. It also ignores the reality that the reserve account is being used for exempt purposes. Disregarding membership receipts when actually received permits manipulation of advertising deductions and allocations. The court's holding on the fourth issue touches upon the question of how periodical income may be consolidated. Further consideration of this issue is required. The holding on the final issue with respect to allocating the reduced dues of interns, residents, and students is somewhat less troublesome than the first two

holdings. In retrospect, it might have been overly zealous to attempt to attribute an $18 subscription price to members who pay only $15 in dues. However, the court's formula is less than satisfactory and results in only $1.05 and $2.35 being allocated for students, and interns and residents, respectively. Conceivably the most harmful aspect of this decision is the invalidation of Reg. 1.512(a)-1(f)(4). The Service position is that the regulation was properly promulgated, and the final regulation was adopted in conformance with the Administrative Procedure Act.

At the time this topic was being written, no final decision had been reached as to whether the case will be appealed. However, it seems likely that either AMA or the Government will appeal one or more of the court's holdings.

C. Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner, No. 87-1358 (7th Cir. 1987)

On November 17, 1987, the Court of Appeals for the Seventh Circuit upheld the Tax Court's decision that income from advertising appearing in the organization's magazine, The Trooper, is subject to tax on unrelated business income. The Tax Court had held that the publishing of advertising is unrelated trade or business under IRC 513, and that amounts derived from such activity are not excluded as royalties under IRC 512(b)(2). On appeal the organization argued that publication of its "paid business listings" in The Trooper does not constitute a trade or business, that IRC 513(c) does not apply to noncommercial advertising, and that there must be a finding of unfair competition. The Court of Appeals rejected the organization's arguments, stating that the "paid listings" constitute commercial advertising, and that a specific finding of unfair competition is not always required to determine which activities constitute trade or business. In the Court's view, evidence of unfair competition is only one factor to be considered and is not dispositive of the issue. With regard to the royalty question, the Court of Appeals upheld the Tax Court's finding that the organization was an active participant in the publication of The Trooper and, therefore, the royalty modification is inapplicable.

4. Social Clubs

A. North Ridge Country Club v. Commissioner

Last year's CPE article on Developments in Unrelated Business Taxable Income, beginning at p. 22, discussed two conflicting Circuit Court decisions on whether exempt social clubs may deduct from investment income losses from food

and beverage sales to nonmembers. The Tax Court recently issued another opinion on this issue in North Ridge Country Club v. Commissioner, 89 T.C. No. 40 (September 15, 1987).

Background

The Service position on this issue is contained in Rev. Rul. 81-69, 1981-1 C.B. 351, which discusses a social club, recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(7), that has unrelated business taxable income from investments made for profit. The club also sells food and beverages to nonmembers at prices insufficient to recover the costs of such sales. Sales of food and beverages to nonmembers have consistently over a number of years resulted only in losses, which are expected to continue. The revenue ruling concludes that because the club's sales of food and beverages to nonmembers are not profit motivated, the club may not deduct losses from sales to nonmembers from its net investment income.

Cleveland Athletic Club v. United States, 779 F.2d 1160 (6th Cir. 1985) concerns a situation, which is very similar to that described in Rev. Rul. 81-69. The court held that the Club may net the excess expenses attributable to sales of food and beverages to nonmembers against its investment income. The court based its opinion on an interpretation of IRC 512(a)(3)(A) whereby deductions need not necessarily come within IRC 162 as a trade or business, but are allowable as ordinary and necessary to the production of income with a basic purpose of economic gain. The court stated that the Club nonmember business activity need not generate a tax profit, and that the nonmember activities were not carried out as hobby rather than as a trade or business. The court also invalidated Rev. Rul. 81-69.

The Brook, Inc. v. Commissioner, 799 F.2d 833 (2d Cir. 1986) concerned another situation, which is similar to Cleveland Athletic Club. The Court held that The Brook improperly used its losses from serving meals to nonmembers to write off a portion of its gross income from its investment activity. The court stated that the "plain language" of IRC 512(a)(3)(A) required that a social club may only deduct an expense if Chapter 1 authorizes that deduction. Since The Brook stipulated that it had no profit motive when it engaged in the unrelated activity of selling meals to nonmembers, deductions of losses from this activity were not allowed.

Facts

North Ridge Country Club is also a social club recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(7). It operates a golf club, restaurant and bar, swimming pool and tennis courts for the benefit of members and guests. In 1979 North Ridge derived revenues from nonmember activities, including golf, golf cart rentals, food sales, beverage sales, and guest fees. Approximately $ 10,000 in interest income was received by the Club, with revenues from golf and golf carts amounting to less than $ 5,000. Over $ 19,000 in losses were generated from the sale of food and beverages to nonmembers. During the five years prior to 1979, golf, golf cart rentals and interest income generated profits for the Club, while food and beverage sales to nonmembers showed consistent losses. For each year, the losses were significant enough that when all nonmember activities were aggregated, an overall loss resulted.

In order for nonmembers to use the Club's golf facilities for tournaments, a number of requirements must be met. Participants must use golf carts rented from the club; prizes must be purchased from the Club's Pro Shop, with a guaranteed minimum expenditure; and, the Club's dining facilities must be used for a banquet or a luncheon. Food and beverage sales are also made outside of golf tournament activities. The court viewed the appropriate categories of nonmember activity as encompassing golf tournaments (with attendant food and beverage sales), and other food and beverage sales independent of the tournaments. The court found that in setting prices for nonmember activities, the Club attempted to strike a balance between maximizing revenue and competing with other establishments. As long as nonmember activities generate revenues in excess of direct costs, the Club believes that it realized both positive cash flow and partial defraying of fixed (indirect) expenses, such as depreciation and property taxes.

Holding

The court's ultimate finding of fact is that North Ridge Country Club was engaged in all of its nonmember activities with the intention of making a profit. This finding was based on the incremental increase of available funds, whereby the Club was profited by each dollar earned over and above the direct costs of such activity. The Government argued that taxable income should be analyzed to determine whether a profit motive exists. In the Government's view, since the Club is allowed to deduct an allocable portion of fixed or direct costs, such amounts should be considered in determining profit motivation. The court rejected this argument, holding that: "The record as a whole makes it apparent that petitioner was seeking profit from these activities and we so hold." The court further held that

losses from one profit motivated transaction may be deducted against the revenue from another. Both Cleveland Athletic Club and The Brook, Inc. were cited by the court and held to be distinguishable.

Postscript

At the time this article was being prepared, no decision had been made as to whether North Ridge Country Club would be appealed. Any such appeal would be to the Ninth Circuit, which has not yet considered the issue of deduction of losses from nonmember sales of food and beverages. If North Ridge were appealed, the appellate court decision, whether favorable or adverse, would create an active conflict in the Circuits, and could serve as a vehicle for Supreme Court consideration.

At this time the Service position, as expressed in Rev. Rul. 81-69, should be applied in all cases.

B. Framingham Country Club v. United States

Another decision affecting a social club's liability for tax on unrelated business income is Framingham Country Club v. United States, 87 USTC par. 9309 (D.C. Mass. 1987). There, the court considered whether an exempt social club could postpone the recognition of income from an option fee, or treat the income as a capital gain.

Facts

The Club, which is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(7), operated a golf course, a clubhouse and a dining room, locker rooms, tennis courts and a swimming pool. The Club purchased approximately 100 acres of real estate in the 1950's for the purpose of expanding its golf course. Of the 100 acres, 30 were used for expansion of the golf course. In 1968, 20 additional acres were purchased, of which two or three acres were used for expansion of the golf course. The Club decided to sell 60 acres of the unused real estate and entered into an Option Agreement with a commercial organization. Under the terms of this Agreement the Club granted a six month renewable option to purchase the 60 acres. The Club received $ 25,000 as consideration for executing the Option Agreement. The renewable provision of the Option Agreement was exercised, and the Club received an additional $ 25,000 payment. Ultimately, the option to purchase was not exercised by the commercial

organization, and the option was allowed to lapse. Subsequently, the property was sold to another party.

The Service determined that the $ 50,000 option fee was unrelated business taxable income. The Club disagreed with this conclusion, and asserted that the non-recognition of gain provision under IRC 512(a)(3)(D) was applicable to the income received from the lapsed option. In accordance with this provision, if property used directly in the performance of the exempt function of a social club is sold by the club, and within a certain period of time other property is purchased and used directly in the performance of exempt purposes, then any gain from the sale is recognized only to the extent the sales price of the old property exceeds the cost of the new property. The Club cited IRC 1234 and argued that under this provision gain resulting from the lapse of an option should be treated as gain from a sale or exchange of property.

Holdings

The Court rejected the Club's arguments, and held that IRC 512(a)(3)(D) is not applicable to income received from an option on the sale of property. The court found an option on the sale of property to be distinguishable from the sale of property itself, which would be covered by IRC 512(a)(3)(D). With respect to IRC 1234, the court noted that such provision addresses the tax treatment accorded options by taxpayers who are holders of options. In this case the Club is the grantor of the option. The regulations under IRC 1234 were cited for the proposition that gain to the grantor of an option arising from the failure of the holder to exercise it is considered ordinary income. The court concluded that the lapse of an option is to be treated as ordinary income to the grantor and not as short-term capital gain resulting from a "sale."

An alternative adverse holding made by the court concerns whether the Club had sufficiently demonstrated that the 60 acres of property were used directly in the performance of the Club's exempt function as required by IRC 512(a)(3)(D). The facts relating to this issue are somewhat unclear. It was stipulated that the 60 acres were "unused real estate." The Government claimed that the land subject to the option was never used by the Club. However, the Club averred that the property was held directly for the provision of golfing facilities. The Club's former Treasurer stated that the Club's greenskeeper lived in a house on the property, and large equipment was stored on the land. The court noted that although the property may have been originally purchased with the intention of providing golfing facilities, the 60 acres in question were never used for that purpose. In the court's

view, there was no justification for holding that use of a home by a greenskeeper and the storage of large equipment directly facilitated the performance of the Club's exempt function.

Postscript

The court's alternate holding in Framingham Country Club v. United States may be inconsistent with certain private letter rulings issued in the past. This issue is currently under study, and consideration should be given to requesting technical advice if similar issues arise. Technical advice should be requested in accordance with IRM 7(13)12.

5. Sale of Low Cost Articles

The Tax Court recently considered whether an organization's Christmas card program results in unrelated business taxable income in Veterans of Foreign Wars, Department of Michigan v. Commissioner, 89 T.C. No. 2 (July 2, 1987).

Background

Reg. 1.513-1(b) discusses the distribution of low cost articles. The regulation provides that where an activity does not possess the characteristics of a trade or business, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply, since the organization is not in competition with taxable organizations. The regulations do not contain a definition of "low cost articles." Amounts received from greeting cards that were mailed as part of a program of solicitation of contributions were held not to constitute unrelated business taxable income in Hope School v. United States, 612 F.2d 298 (7th Cir. 1980), and Veterans of Foreign Wars of the United States v. United States, 601 F. Supp. 7 (W.D. Mo. 1984). In Disabled American Veterans v. United States, 650 F.2d 1178, the court held that the organization received unrelated business income only from a $5 premium portion of a special solicitation of contributions program. Amounts received from lesser valued premiums sent to potential contributors were held not to constitute unrelated business taxable income because the activity was not conducted "in a commercial, competitive manner."

In order to clarify this issue, Congress enacted IRC 513(h)(1)(A) as part of the Tax Reform Act of 1986. This provision holds that for exempt organizations that are eligible to receive deductible contributions under IRC 170(c)(2) or (3) the

term "unrelated trade or business" does not include activities relating to the distribution of low cost articles, if the distribution of such articles is incidental to the solicitation of charitable contributions. "Low cost article" is defined as any article with a cost of $5 or less to the organization distributing the item. For further information on IRC 513(h), see section (36)86 of IRM 7751.

Although Congress appears to have resolved the question of low cost articles by enacting IRC 513(h), this provision is only applicable to distributions of low cost articles after October 22, 1986. Thus, the issue of low cost articles may still arise for years prior to that date. In Veterans of Foreign Wars, Department of Michigan v. Commissioner, the taxable years in question were 1975, 1976, and 1977.

Facts

Veterans of Foreign Wars, Department of Michigan (VFW) is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(4) and 501(c)(9). Its purposes are fraternal, patriotic, historical, and educational. VFW entered into a contract with a commercial organization (Studios), which agreed to prepare boxes of Christmas cards and send them to individuals appearing on a list provided by VFW. Each package sent to an individual appearing on the list included a cover letter, a box of 20 Christmas cards, a return envelope and a remittance card. The cover letter asked the recipient to pay $2.00 in 1975 and $3.00 in 1976 and 1977, and stated that contributions were tax deductible. The materials indicated that the cards were sent as part of an approved program and "should not be considered unsolicited." Studios sent out three reminder notices per year to those who did not respond initially. VFW was involved in the Christmas card program for about one week of time per month from September through February of each year. Studios provided a number of services including preparing and providing Christmas cards, envelopes and boxes; preparing and providing cover letters; and maintaining files. In 1975 VFW paid Studios $.89 for each Christmas card package distributed; $1.15 was paid in 1976 and 1977. Approximately 50,000 boxes were shipped during each of the three years. Studios provided similar services to other exempt organizations and, during the three years in question, its share of the Christmas card market was 1.52 percent, 1.84 percent, and 2.12 percent, respectively.

Holdings

On these facts, the court made the following holdings:

1. VFW conducted the Christmas card program with the predominant intent of producing income;

2. The Christmas card program was in substance the sale of goods;

3. The program was a regularly carried on trade or business;

4. The program was in competition with Christmas cards marketed by commercial entities;

5. Apart from the use of the profits derived, the program had only an incidental effect on VFW's exempt purposes; and

6. The fair market value of the Christmas cards was $ 2.00 in 1975 and $ 3.00 in 1976 and 1977. Individuals who paid more than these amounts made a gift to VFW.

Rationale

The court stated that it believed VFW conducted the Christmas card program in order to produce income, and would not have conducted the program if it had not produced income. VFW advanced the argument that because state and federal law permitted recipients of unsolicited items to treat them as gifts, the Christmas cards were, as a matter of law, gifts. In view of the fact that VFW attempted to persuade the recipients that the cards were not unsolicited, the court declined to permit VFW to "hide behind these statutes." All of the facts indicated that there was an exchange of boxes of Christmas cards for a sum specified by VFW, and on this basis the activity was a trade or business under IRC 513(a) and (c).

With respect to competition, the court noted that the tax on unrelated business income is not only applicable where there is unfair competition. However, in this case, Studios, the commercial supplier, had a significant portion of the Christmas card market, and VFW's product displaces and competes with Christmas cards marketed by commercial entities. The court stated the following: "This is precisely the type of situation to which the unrelated business income tax provisions were designed to apply."

The "low cost articles" provision under Reg. 1.513-1(b) was deemed to be inapplicable in this case. The Christmas cards were within a reasonable range of

their retail values, and were not low cost articles. The court cited Disabled American Veterans v. United States, supra, and stated that this opinion supported the Government's case. Hope School v. United States, supra, was also cited, but the court viewed the lack of evidence of competition as being crucial in Hope School. Here, there was sufficient evidence of competition.

The requirement that an activity be "regularly carried on" in order for an unrelated trade or business to be subject to tax was also discussed. Comparing VFW's Christmas card activities to those of other exempt organizations, the court stated that VFW's activities "ordinarily" would be considered regularly carried on. However, when comparing VFW's activities with those of commercial enterprises, the result is less certain. Although the activities were conducted without promotional efforts typical of commercial endeavors, the Christmas card sales were not merely casual but were systematically and consistently promoted and carried on. Suffolk County Patrolmen's Association v. Commissioner, 77 T.C. 1314 (1981), which held that the sale of advertising in connection with a vaudeville show held one weekend per year, was thought to be distinguishable. The court analyzed all the facts, and concluded that treating the Christmas card program as regularly carried on was consistent with Congressional intent.

Despite VFW's argument that the Christmas card program enhances the "good feelings of members", the court stated that the program did not contribute importantly to the organization's exempt purpose, other than by producing income. Thus, the "substantially related" test was not met. Also rejected was VFW's argument that amounts received from the Christmas card program were "voluntary dues."

Regarding the fair market value of the Christmas cards, VFW argued that each box was worth $1.45, $1.59 and $1.77 during 1975, 1976, and 1977, respectively. Amounts received in excess of the fair market value would constitute a gift by the payor. The Government argued that $5.00 per box is the more accurate figure. The court stated that the relevant market for determining fair market value is retail or direct sales by the box. In the court's view, the requested amounts - $2.00 in 1975, and $3.00 in 1976 and 1977 - approximate fair market value. Those paying more than the requested amounts made a gift to VFW, and such amounts are excludable from unrelated business taxable income. Other than those amounts, the court held that receipts from VFW's Christmas card program are subject to the tax on unrelated business income.

6. New Issues

A. Credit Cards

Exempt organizations appear to be entering into agreements with financial institutions (typically banks) that send credit cards to the organizations' members. Under these agreements, for each member who applies for the bank's credit card, the exempt organization receives an agreed upon amount together with a specified percentage (typically one-half of one percent) of total charges made to the card by the member. The exempt organization also receives a specified amount for members who renew their cards. The September 24, 1987, edition of the Wall Street Journal described these so-called "affinity cards" as "making waves in the credit card market." The issue presented is whether amounts received by an exempt organization from such credit card activities are unrelated business taxable income. In reaching this decision, consideration will have to be given to whether such amounts might be royalties under IRC 512(b)(2).

B. Portable X-Ray Services

Portable x-ray services are provided generally to elderly, nonambulatory individuals, who are usually nursing home residents. These services are provided by qualified technicians on the order of a physician. Typically, the attending physician at the nursing home determines that his or her patient needs an x-ray, and informs nursing home personnel of this. The nursing home then calls on the portable x-ray provider to come to the nursing home to x-ray the individual. When an exempt hospital provides portable x-ray services to nursing home residents, the question arises as to whether amounts received in connection with this activity are unrelated business taxable income. The basic issues are whether portable x-ray services are substantially related to a hospital's exempt purpose and, if not, whether such services are provided for the convenience of patients under IRC 513(a)(2). In determining whether a nursing home resident is a hospital patient, the examples of patients given in Rev. Rul. 68-376, 1968-2 C.B. 246, would be useful.

Consideration should be given to requesting technical advice under IRM 7(13)12 for cases involving issues of credit cards, portable x-ray services, and any other activities that might result in unrelated business income for which there is no published precedent.